DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 03-0332
Indiana Corporate Income Tax
For Taxpayer's First Short Tax Period of 1997

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ISSUES

I. **Applicability of the Adjusted Gross Income Tax and Gross Income** – Taxpayer's Income from Licensing Trademarks and Trade Names.

Authority: IC 6-2.1-2-2; IC 6-3-2-2(a); IC 6-3-1-1 et seq.; Indiana Dept. of State Revenue v. Bethlehem Steel Corp., 639 N.E.2d 264 (Ind. 1994); Thomas v. Indiana Dep't of State Revenue, 675 N.E.2d 362 (Ind. Tax. Ct. 1997); 45 IAC 1-1-51; 45 IAC 3.1-1-55.

Taxpayer argues that money it received from licensing its trademarks and trade names for use within the state is not subject to state income tax because these intellectual properties do not have an Indiana business situs.

II. **Computational Errors**.

Authority: IC 6-8.1-5-1(b).

Taxpayer maintains that even if the money received from licensing intellectual property is found to be subject to the state's income tax, the audit report contained computational errors which now require correction.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of operating and managing fast-food restaurants. It conducts this business by means of various subsidiaries and through local franchisees.

During 2003, the Department of Revenue (Department) conducted an audit review of taxpayer's business records. The Department concluded that taxpayer was receiving income from licensing its intellectual property within the state and that taxpayer should have been filing Indiana corporate income tax returns. Accordingly, the Department assessed taxpayer for unpaid income tax attributable to taxpayer's first short tax period of 1997.

Taxpayer disagreed with the conclusions contained within the audit report on the ground that the intellectual property had not acquired an Indiana business situs. Taxpayer submitted a protest to that effect on May 11, 2004. An administrative hearing was conducted during which taxpayer further explained the basis for its protest. This Letter of Findings results.

DISCUSSION

I. **Applicability of the Adjusted Gross Income Tax and Gross Income** – Taxpayer's Income from Licensing Trademarks and Trade Names.

Following the audit of taxpayer's business records, the Department concluded that taxpayer was subject to the state's gross income tax and adjusted gross income tax on the ground that taxpayer was licensing the use of intangibles within Indiana. Taxpayer disagrees maintaining that the intangibles – intellectual property consisting of trademarks and trade names – did not have a business situs within Indiana and that the income derived was not subject to the state's corporate income tax scheme.

Taxpayer licenses franchisees to sell fast food within the state. As part of the agreement with the individual franchisee, the franchisee is granted the right to use what taxpayer calls its fast food "system." The system includes "distinctive signs, food recipes, uniforms, and various trade secrets and other confidential information . . . ." Taxpayer's "system" is identifiable to Indiana consumers by "certain trademarks, trade names, service marks, symbols, emblems, logos, designs, and other indicia of origin." The parties' franchise agreement collectively describes this identifying property as the "Company's Marks." Although the agreement stipulates that taxpayer continues to retain complete ownership of the "company's marks," the agreement grants the franchisee the right to use the marks in order "to identify for the public the source of the services rendered in accordance with the System and the high standards of quality attendant thereto[.]"

After entering into an agreement with a local franchisee restaurant, taxpayer retains the right to exercise control over the operation of the franchisee's business. Taxpayer retains the right to both prescribe and proscribe the food items sold at the franchise location, requires the franchisee to identify its business as part of the taxpayer's "system" of restaurants," and requires the franchisee adopt a particular, unified menu format. In addition, the taxpayer retains the right to have its "authorized representative . . . enter upon the premises of Operator's System Restaurants at any reasonable time for the purpose of examining same, conferring with Operator's employees, inspecting and checking operations, food, beverages, furnishings, interior and exterior décor, supplies, fixtures, and equipment, and determining whether the business is being conducted in accordance with [taxpayer's] standards and the terms of [the franchise] agreement."

The parties' franchise agreement circumscribes the individual franchisee's right to use taxpayer's intellectual property. The local franchisee is given the right to use the intellectual property for purposes of identifying the local franchise business as part of taxpayer's "system" of restaurants, but the right to use the identifying intellectual property is limited to the individual franchisee's restaurant and defined territory. The franchisee is not entitled to "license or attempt to license any other person or firm to use [taxpayer's] marks." By the terms of the agreement, the franchisee agrees that "all goodwill arising from operator's use of [taxpayer's] Marks and

System inures to [taxpayer].” In addition, the local franchisee agrees to “indemnify [taxpayer] for any damage or expense occasioned by Operator’s improper use of said Marks.”

In the event that the franchise agreement terminates or is terminated, the local franchisee is required to “remove all identifying architectural superstructure and characteristics from the [franchisee’s] building as [taxpayer] may direct in order to effectively distinguish the same from [taxpayer’s] building design.” In the event that the agreement is terminated, taxpayer retains “the right to enter upon the premises to make or cause to be made such changes at the expense of Operator . . . which expense Operator agrees to pay on demand.”

The terms of the parties’ agreement evidence the fact that taxpayer attaches great value to its intellectual property. The agreement expressly states that the elements comprising taxpayer’s restaurant system “are unique and distinctive and have been developed at great effort, time, and expense.”

In return for the right to make use of taxpayer’s “system” and identifying intellectual property, the local franchisee pays taxpayer an initial franchise fee and agrees to pay a monthly service fee ranging between four and four and one-half percent of the franchisee’s gross sales.

The issue is whether the income attributable to the licensing of taxpayer’s intellectual property is subject to Indiana’s corporate income tax scheme. Taxpayer concludes that the income is not subject to the tax because the intellectual property never acquired an Indiana situs. Instead taxpayer maintains that all activity associated with “the maintenance, administration, and protection of the trademarks and trade names . . . occurred outside the state of Indiana . . . .”

A. Adjusted Gross Income Tax.

Indiana imposes an adjusted gross income tax on income derived from sources within the state. The adjusted gross income tax, IC 6-3-1-1 et seq., is an apportioned tax specifically designed to reach income derived from interstate transactions. Thomas v. Indiana Dep't of State Revenue, 675 N.E.2d 362, 367-68 (Ind. Tax. Ct. 1997); Indiana Dept. of State; *See also* Revenue v. Bethlehem Steel Corp., 639 N.E.2d 264, 266 n. 4 (Ind. 1994). The legislature has defined “adjusted gross income” as follows:

> (1) income from real or tangible property located in this state; (2) income from doing business in this state; (3) income from a trade or profession conducted in this state; (4) compensation for labor or services rendered within this state; and (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter. IC 6-3-2-2(a).

In order for Indiana to tax the income derived from an intangible, the intangible – such as taxpayer’s intellectual property – must have acquired a “business situs” within the state. 45 IAC 3.1-1-55 states that “[t]he situs of intangible personal property is the commercial domicile of the taxpayer . . . unless the property has acquired a ‘business situs’ elsewhere. ‘Business situs’ is the place at which intangible personal property is employed as capital; or the place where the property is located if possession and control of the property is localized in connection with a trade or business so that substantial use or value attaches to the property." 45 IAC 3.1-1-55.

For purposes of Indiana's adjusted gross income tax, it is apparent that taxpayer's intellectual property has acquired a "business situs" within the state. Taxpayer derives income from Indiana franchisees which pay taxpayer for the right to make use of taxpayer's trademarks and trade names in order to sell fast food to Indiana customers at Indiana business locations. Taxpayer may be entirely correct in its assertion that activities associated with the initial development and ongoing administration of the intellectual property take place outside Indiana. However, issues concerning the administration, maintenance, and protection of the intellectual property are finally irrelevant to the tax question here at issue. What is relevant are the royalties taxpayer receives by placing that intellectual property within the state because it is these royalties which represent the "value" of this property. The value attached to the intellectual property does not derive from – however necessary – activities surrounding the administration of the intellectual property outside this state but results from taxpayer's ability to exploit the value of the property within the stream of Indiana commerce and to derive income from its ability to do so. The intellectual property – consisting of words, symbols, color-combinations, and the like – is, standing alone, of no value unless taxpayer takes steps to associate that property with the conduct of a specific business operation. Taxpayer is not paid royalties because it successfully administers the intellectual property at an out-of-state location; taxpayer receives income because it licenses Indiana franchisees to associate that intellectual property with the Indiana franchisees' fast food business.

The terms of the parties' franchise agreement clearly indicate that taxpayer has placed a substantial value on these particular properties. It is, therefore, quite proper that taxpayer take steps to protect the property when it licenses Indiana franchisees to make use of the property within the state. However, the assertion that the intellectual property has not acquired an Indiana business situs is simply without foundation in law or common sense. Indeed, taxpayer's trademarks and trade names have become a ubiquitous part of the Indiana landscape. Taxpayer, having taken calculated steps to "dip its net" into the stream of Indiana commerce and derive Indiana income directly attributable to exploiting its intellectual capital within the state, should not be surprised that the income is subject to Indiana income tax. As the regulation itself states, "'Business situs' is the place at which [the] intangible personal property is employed as capital . . . ." 45 IAC 3.1-1-55. The place at which "value attaches to the [intellectual] property" is within the state of Indiana. Id.

B. Gross Income Tax.

In addition to the adjusted gross income tax, Indiana imposes a tax known as the "gross income tax" on the "taxable gross income" of a taxpayer which is a resident or domiciliary of Indiana and on the taxable gross income from Indiana sources by a taxpayer who is not a resident or domiciliary of Indiana. IC 6-2.1-2-2.

Under the regulation governing the gross income tax, "taxable gross income" includes income that is derived from "intangibles." 45 IAC 1-1-51. The term "intangibles" includes:

> notes, stocks in either foreign or domestic corporations, bonds, debentures, certificates of deposit, accounts receivable, brokerage and trading accounts, bills of sale, conditional sales contracts, chattel mortgages, "trading stamps," final judgments, leases, royalties, certificates of sale, choses in action *and any and all other evidences of similar rights capable of being transferred, acquired or sold.* (*Emphasis added*). Id.

In order for Indiana to impose the gross income tax on income derived from taxpayer's intangibles, the Department must determine that the income is derived from a "business situs" within the state. Id. The regulation states that a taxpayer has established a "business situs" within the state "[i]f the intangible or the income derived therefrom forms an integral part of a business regularly conducted at a situs in Indiana . . . ." Id. Once the taxpayer has established a "business situs" within the state, "and the intangible or the income derived therefrom is connected with that business, either actually or constructively, the gross receipts of those intangibles will be required to be reported for gross income tax purposes." Id.

The income derived from the taxpayer's licensing of its intellectual property within the state, is income derived from a "business situs" within Indiana and is properly subject to the state's gross income tax scheme. The intellectual property is "localized" within the state because the intellectual property is integrally related to the fast food restaurants which sell food items labeled, promoted, and marketed using taxpayer's proprietary trademarks and trade names. The income at issue is not derivative of taxpayer's out-of-state activity in developing, managing, and protecting the intellectual property; the value of this intellectual property lies in taxpayer's ability to license the property for use within Indiana, to maintain rigorous control over the use of the property by its franchisees, and to derive the economic benefits attributable to the intangible property's Indiana business situs.

Accordingly, because the intangible intellectual property has acquired a business situs within the state and because the income at issue is "connected with that business, either actually or constructively," the income is subject to the state's gross income tax.

FINDING

Taxpayer's protest is respectfully denied.

II. Computational Errors.

Taxpayer argues that the audit report contains computational errors. For example, taxpayer states that the report's listing of "royalties received from Indiana" sources" represents income received during a 12-month period but that the report itself was intended to cover less than a 12-month period. In addition, taxpayer states that the proposed assessment "includes an adjustment to reverse the net capital loss included in Federal taxable income." Taxpayer states that, in making this adjustment, the audit failed to distinguish properly between "business" and "non-business" income.

IC 6-8.1-5-1(b) states that, "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

The administrative hearing process is not the means by which the purported computational errors may be analyzed, corrected, or refuted. Nonetheless, taxpayer has met its burden under IC 6-8.1-5-1(b) of demonstrating that its numerous assertions are neither frivolous nor groundless. Accordingly, the audit division is requested to undertake a supplemental review of the specific claimed errors and make whatever corrections it deems appropriate.

FINDING

Subject to the results of the supplemental audit review, taxpayer's protest is sustained.

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